STOCK REDEMPTIONS UNDER SECTIONS 302 AND 306 OF THE 1954 CODE AND TAX PLANNING FOR SHAREHOLDERS TERMINATING THEIR INTEREST IN CLOSELY-HELD CORPORATIONS: REVENUE RULING 77-455*

INTRODUCTION

In closely-held corporations the tax planner is frequently confronted with determining the tax consequences, if any, of a corporate stock distribution to the corporation's shareholders. Under the 1954 Code, one of the primary considerations of the tax specialist is whether the stock dividend should be treated as a distribution of property included in the shareholder's gross income. Once it is determined that the stock distribution is not includable in the shareholder's gross income, the taxpayer must confront the possibility that when any or all of his stock interest is terminated he may be subjected to unfavorable tax treatment. Revenue Ruling 77-455 concerns the tax consequences of a shareholder who sells a portion of his stock to his son and the remaining shares are re-


1. The classic case of Eisner v. Macomber, 252 U.S. 189 (1920) held that a distribution of common stock could not be constitutionally taxed as income to the shareholder. The majority stated:

   A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the shareholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

   Id. at 211. For a discussion of the implications of Eisner, see generally Rottschaefer, Present Taxable Status of Stock Dividends in Federal Law, 28 MINN. L. REV. 106 (1943); Seligman, Implications and Effects of the Stock Dividend Decision, 21 COLUM. L. REV. 313 (1921).

   Later Supreme Court opinions have taken some of the force out of the Eisner holding. See, e.g., Koshland v. Helvering, 298 U.S. 441 (1936); Helvering v. Griffiths, 318 U.S. 371, 404 (1943) (Douglas, J., dissenting).

   2. All statutory references herein are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

   3. The term "stock dividend" is used with reference to a dividend paid by the distributing corporation with its own stock.
deemed by the corporation. The Internal Revenue Service indicates that, in certain factual situations, unfavorable tax treatment can be avoided upon termination of the shareholder's interest.

Section 305 of the Code provides that "gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock" except if: (1) the distribution is payable, at the election of any of the shareholders, in either stock or property; (2) the distribution has as its result the receipt of property by some shareholders and an increase in the proportionate equity interests of the other shareholders; (3) the distribution results in a receipt of preferred stock by some shareholders and a receipt of common stock by other shareholders; (4) the distribution is with respect to preferred stock; and (5) the distribution is of convertible preferred, unless it is established that it will not bring a disproportionate result. Upon a determination that the stock distribution is exempt from section 305 treatment, the shareholder runs the risk that his interest, when terminated, will be treated as a dividend and taxed at ordinary income rates.

There are means by which a tax framework can be established to allow corporate distributions to shareholders to be taxed at capital gains rates as opposed to ordinary income rates upon termination.

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4. 1977-50 I.R.B. 6. The stock sold to the son had been received by distribution while the stock redeemed by the corporation was both original issue and dividend stock.

5. I.R.C. § 305. Section 305 was enacted so that much of the confusion caused by the Eisner decision, § 115(f) of the 1939 Code, and subsequent decisions could be eliminated. See note 1 supra.

6. I.R.C. § 305(a). The distribution by a corporation of another corporation's stock is not within the purview of § 305. This section is limited to distributions of the corporation's own stock. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 7-65 (3d ed. 1971). [hereinafter cited as B. BITTKER & J. EUSTICE].


8. See I.R.C. §§ 301, 302(b), 302(d).

9. See I.R.C. §§ 301(a), 301(c), 316. "By virtue of these provisions, a corporate distribution is a 'dividend' that must be included in the recipient's gross income under § 301(c)(1) and § 61(a)(7) if, and to the extent that, it comes out of earnings and profits of the corporation. . . ." B. BITTKER & J. EUSTICE, supra note 6, at 7-2. Individual ordinary income tax rates graduate from a minimum of 14% to a maximum of 70%. I.R.C. § 1. The capital gain provisions afford beneficial tax treatment for long term capital gains by means of an alternative tax or by an allowance.
tion of all or part of the shareholder's interest. Historically such plans have usually been designated as "bail-outs."\textsuperscript{10} Under such a scheme a corporation with ample earnings and profits would issue to its shareholders preferred stock which would be received tax free.\textsuperscript{11} The shareholder would sell the preferred stock (received as a dividend) and then report his proceeds from the sale as a capital gain.\textsuperscript{12}

In 1954 Congress enacted section 306 in response to the shareholder's receipt of earnings and profits at capital gains rates through the use of bail-outs.\textsuperscript{13} By virtue of this section, a new category of stock was created—section 306 stock\textsuperscript{14}—sale or distribution of which will, in most instances, give rise to ordinary income treatment rather than capital gain treatment.\textsuperscript{15}

**Revenue Ruling 77-455**

Revenue Ruling 77-455\textsuperscript{16} concerns the redemption of common stock and section 306 stock owned by the majority shareholder of

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of a 50% deduction to taxpayers other than corporations. Thus, the maximum rate on such income is 35%. I.R.C. §§ 1201, 1202.
10. "[T]he preferred stock ‘bail-out’ [was] an ingenious but in-imple plan by which shareholders could withdraw corporate earnings and profits as long-term capital gains." B. Birkker & J. Eustice, supra note 6, at 10-1.
For an in-depth discussion of preferred stock bail-outs, see generally B. Birkker & J. Eustice, supra note 6, at ch. 10; Alexander & Landis, Bail-Outs and The Internal Revenue Code of 1954, 65 Yale L.J. 309 (1956); Lowe, Bailouts: Their Role in Corporate Planning, 30 Tax. L. Rev. 357 (1975).
11. Prior to § 305, the determination of whether or not stock distributions were received tax free depended upon case law. See Helvering v. Sprouse, 318 U.S. 604 (1943), which held that a dividend of preferred issue upon common does not render the dividend taxable as income.
12. The advantage to the taxpayer are striking. See note 9 supra.
13. In Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954), the court held under the 1939 Code, that a dividend of preferred stock by a corporation having only common stock outstanding was not rendered taxable even though there was a prearranged plan for its sale and despite a mandatory retirement plan over seven years.
The 1954 Code created a new category of stock—"section 306 stock"—aimed at controlling the situation presented in the Chamberlin case. Section 306 provides that a stock dividend (other than common stock issued with respect to common stock) which meets some of the definitions of § 306(c) is designated as "section 306 stock" and taxed at ordinary income rates upon sale or other disposition in accordance with § 306(a).
See generally B. Birkker & J. Eustice, supra note 6, at 10-3 to 10-10.
14. See I.R.C. § 306(c). Section 306 stock is defined in § 306(c) and is usually preferred stock received as a nontaxable dividend (§ 305) or in a transaction in which no gain or loss is recognized. A designation as section 306 stock results merely in a tax classification and is not a creation of a separate stock class for corporate or securities law purposes.
\end{verbatim}
the redeeming corporation, coupled with a sale of the majority shareholder's remaining common and section 306 stock to the majority shareholder's son and other key employees of the redeeming corporation.\textsuperscript{17} The redeeming corporation (hereinafter referred to as Corporation X) has outstanding 115,000 shares of voting common stock and 300,000 shares of voting preferred stock. The majority shareholder (hereinafter referred to as A) owns 69,000 shares of common and all of the preferred. A received the preferred stock in 1969 in exchange for part of his common stock in a "recapitalization plan."\textsuperscript{18} All of the preferred stock is section 306 stock.\textsuperscript{19} A wishes to retire from the business and to terminate all his stock and other interests in Corporation X. He proposes to sell 10,000 shares of common stock and 18,000 shares of preferred stock to his son, sell 25,000 shares of common to a key employee and have the remaining common and preferred stock redeemed by Corporation X. His reason for selling some of the preferred to his son, rather than having all of the preferred stock redeemed, is to leave his son with voting control of Corporation X for a smaller investment than would otherwise be necessary, while giving the key employees a greater participation in the growth of the corporation.\textsuperscript{20} The principal issues before the Internal Revenue Service are: (1) Whether the proposed redemption, in connection with sales of the remaining common and preferred stock of the distributing corporation, will qualify as a "complete termination of interest in the redeeming corporation";\textsuperscript{21} and (2) whether the proposed redemption and sale of the preferred stock will be exempt from ordinary income treatment.

The ruling holds that the proposal by A does qualify as a complete termination of interest and that the disposition of the section 306 stock is exempt from ordinary income treatment.\textsuperscript{22} The Internal Revenue Service discerns that the principal purposes of the

\textsuperscript{17} Id.  
\textsuperscript{18} Id. See I.R.C. § 368(a)(1)(E). A distribution of earnings and profits under a corporate reorganization is an alternative to a declaration of a dividend of preferred stock to the common shareholder. B. BRITTKER & J. EUSTICE, supra note 6, at 14-95 to 14-97.  
\textsuperscript{19} See I.R.C. § 306(c)(1)(B). This section provides that stock received, which is not common stock, in a corporate reorganization is section 306 stock. See also B. BRITTKER & J. EUSTICE, supra note 6, at 14-95 to 14-97.  
\textsuperscript{21} See I.R.C. § 302(b)(3) which provides: "Subsection [302](a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."  
\textsuperscript{22} 1977-50 I.R.B. 7.
STOCK REDEMPTIONS

sale are to enable A to retire from the business and to give his son, who is active and knowledgeable in the affairs of the business, control of Corporation X. The Service rules that tax avoidance is not one of the principal purposes of the proposed sale and redemption. Therefore, this would qualify for the exemption provided by section 306(b)(4)(B).

The purpose of this article is to examine the analysis of the Internal Revenue Service in its ruling and to consider the importance of this ruling as a future tax planning device.

SECTIONS 302 AND 318: STOCK REDEMPTIONS AND THE FAMILY ATTRIBUTION RULES

In general the payment to a shareholder in exchange for his stock will result in capital gain or loss if the stock is a capital asset in the shareholder's hands. Congress by enacting the 1954 Code attempted to prohibit the shareholder from claiming the stock distribution was a sale when in essence the transaction was more like a "dividend." In the area of stock redemptions, the Code provides that unless the redemption qualifies as a distribution in payment for the acquired stock, the entire distribution will be treated as ordinary income to the shareholder.

Section 302(a) of the Code stated that a stock redemption shall be treated as an "exchange", as set forth in section 302(b), if: (1) the redemption is "not essentially equivalent to a dividend;" (2)
the distribution is "substantially disproportionate" with respect to the shareholder;\(^3\) (3) the redemption is a "complete redemption" of all stock held by the shareholder;\(^3\) or, (4) the redemption is of stock issued by a railroad corporation.\(^3\) Of the four, section 302(b)(3), relating to the complete termination of interest by a shareholder, is of primary importance in Revenue Ruling 77-455.

Prior to the enactment of the 1954 Code the Internal Revenue Service regarded a redemption in complete termination of the shareholder's interest as a sale, rather than as a distribution essentially equivalent to a dividend.\(^3\) Under section 302(b)(3), the Code provides a redemption shall be treated as a distribution in full or part payment in exchange for stock "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."\(^3\) If the redemption qualifies under section 302(b)(3), it will qualify as an exchange under section 302(a) and will thus be given capital gains treatment.\(^3\)

The Service, in Revenue Ruling 77-455, relied on Zenz v. Quinlivan\(^3\) to determine that the proposed sale by A of a portion of his stock to his son and the subsequent redemption by Corporation X were part of an integrated plan to terminate A's interest in the corporation and therefore not subject to dividend treatment.\(^3\)

In Zenz the sole shareholder of a corporation, desiring to dispose of her entire interest therein, sold part of her stock to a competitor and, shortly thereafter, surrendered her remaining stock to


33. I.R.C. § 302(b)(3).

34. I.R.C. § 302(b)(4). This is special legislation for certain railroad corporations.

35. See Treas. Reg. 118, § 39.115(g)-1(a)(2) (based on the 1939 Code) which provides in relevant part:

A cancellation or redemption by a corporation of a portion of its stock pro rate among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend. . . . On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of taxable dividend.

Id. See also Ferris v. United States, 135 F. Supp. 286, 288 (Ct. Cl. 1955) (despite the language of § 115(g) of the 1939 Code, a shareholder escaped § 115 on redemption of part of his interest); Howell v. Commissioner, 26 T.C. 846 (1956); Tiffany v. Commissioner, 16 T.C. 1443 (1951); Rev. Rul. 54-408, 1954-2 C.B. 165.


38. 213 F.2d 914 (6th Cir. 1954).

the corporation for redemption. The Commissioner contended, and the district court agreed, that the plan implemented by the taxpayer was a circuitous approach by which the taxpayer attempted to receive the earnings and profits of the corporation at capital gains rates. The Sixth Circuit Court of Appeals reversed and held that the redemption, coupled with the earlier sale, extinguished the shareholder's interest in the corporation. The court reasoned that, since the intent of the taxpayer was to terminate her entire interest in the corporation, the result was inevitable that the distribution of the earned surplus by the corporation for the stock "was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend."

As set forth in Zenz, if the redemption is part of an undertaking which will completely terminate the shareholder's interest in the corporation, the redemption should allow capital gains treatment for the shareholder. Nevertheless, caution should be used when the plan is to extend over an indefinite period of time during which the shareholder retains control over the corporation. In this situation, the redemption will not be viewed as giving rise to capital gains treatment, but rather the redemption will be considered a dividend distribution.

While termination of interest is an important consideration, the tax planner should be aware that the paramount significance of section 302(b)(3) is its waiver under certain circumstances of

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40. 213 F.2d at 916. Zenz involved the use of a device known as bootstrap financing.

A plan by which a shareholder terminates his interest is called a bootstrap acquisition when the transaction is financed with funds belonging to the corporation being acquired. See generally Jassy, The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route vs. The Dividend Route, 87 HARV. L. REV. 1459 (1974); Kingson, The Deep Structure of Taxation: Dividend Distributions, 85 YALE L.J. 861 (1976).


42. 213 F.2d at 917.


44. 213 F.2d at 917-18. See also Arthur D. McDonald, 52 T.C. 82 (1969) which held that the redemption of preferred stock, coupled with the exchange of common stock in a tax-free reorganization under § 368(a)(1)(B), was not equivalent to a dividend under § 302(b)(1) and Zenz. See Rev. Rul. 75-447, 1975-2 C.B. 113.

45. See Friend v. United States, 345 F.2d 761, 765 (1st Cir. 1965). But cf. United States v. Carey, 289 F.2d 531 (8th Cir. 1961) (where a shareholder redeemed a portion of his stock to reduce the "asking price" so another buyer could be found for the remaining stock. The court found this to be a legitimate business purpose—eliminating one shareholder and obtaining another. Therefore, the redemption was not essentially equivalent to a dividend).
the family attribution rules of section 318.\textsuperscript{46} Section 302(c)(2) provides that, for purposes of section 302(b)(3), the family attribution rules may be waived if: (1) immediately after the distribution the shareholder has no interest in the corporation (including an interest as an officer, director, or employee) other than an interest as a creditor; (2) the shareholder does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of the distribution; and (3) the shareholder files an agreement to notify the Secretary of any acquisition of prohibited interest during the ten-year period.\textsuperscript{47}

An example of section 302(c)(2)(A)(i). Revenue Ruling 70-104\textsuperscript{48} concerned a redemption whereby the corporation, owned by a father and his children, would distribute cash upon the redemption of all of the stock owned by the father. The corporation and redeeming shareholders entered into a five-year consulting agreement which provided that the father would perform services as a consultant and advisor to the corporation in exchange for compensation of $10,000 per year.\textsuperscript{49} The Internal Revenue Service held that the services pursuant to the consulting agreement were an "interest in the corporation" within the meaning of section 302(c)(2)(A)(i) of the Code and therefore, the Code did not waive the attribution to him under section 318(a)(1).\textsuperscript{50}

However, in \textit{Estate of Lennard v. Commissioner},\textsuperscript{51} the father continued to provide monthly accounting services to the corporation after he redeemed his stock and resigned as a director and officer of the corporation. The Tax Court found Revenue Ruling 70-104 not to be controlling.\textsuperscript{52} The Court reasoned that it was not the intent of Congress to include independent contractors "possessing no financial stake in the corporation among those who are considered as retaining an interest in the corporation for purposes of the attribution waiver rules."\textsuperscript{53} Revenue Ruling 70-104 was held inap-

\textsuperscript{46} I.R.C. § 318(a) provides that a taxpayer will be considered constructive owner of stock owned directly or indirectly by or for his spouse, children, grandchildren and parents. \textit{See generally} B. Bittker & J. Eustice, \textit{supra} note 6, at 9-10 to 9-16, 9-19; Ringel, Surrey & Warren, \textit{Attribution of Stock Ownership in the Internal Revenue Code}, 72 HARV. L. REV. 209 (1958); Winton & Hoffman, \textit{A Case Study of Stock Redemptions Under Sections 302 and 318 of the New Code}, 10 TAX. L. REV. 363 (1955).

\textsuperscript{47} I.R.C. § 302(c)(2)(A).

\textsuperscript{48} 1970-1 C.B. 66.

\textsuperscript{49} Id.

\textsuperscript{50} Id.

\textsuperscript{51} 61 T.C. 554 (1974).

\textsuperscript{52} Id. at 560.

\textsuperscript{53} Id. at 561. \textit{But cf.} Rev. Rul. 75-2, 1975-1 C.B. 99 (attribution rules were not waived when the son who was executor of the estate of his sole shareholder father, became president of the corporation within 10 years from the date of redemption).
applicable since there was no employment contract thereby, the father's relationship with the company might terminate at any time, and the father was not attempting to transfer the business to his son while retaining control over the operations of the corporation.\textsuperscript{54}

However, section 302(c)(2)(B)(ii) provides that the family attribution rules shall \textit{not} be waived if:

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[A] ny person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee [a person entitled to share in the distribution] under section 318(a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.\textsuperscript{55}
\end{quote}

But if the distribution by the distributee did not have as one of its principal purposes the avoidance of Federal income tax, then the general rule of section 302(c)(2)(B)(ii) will not apply and constructive stock ownership may be waived if the distributee complies with the rules of section 302(c)(2)(A).\textsuperscript{56}

Revenue Ruling 77-293\textsuperscript{57} involved a plan by which the sole shareholder of a corporation gave fifty per cent of his interest to his son for the purpose of giving his son control of the corporation.\textsuperscript{58} Shortly thereafter, the remaining interest of the father was to be redeemed by the corporation.\textsuperscript{59} The Internal Revenue Service held that since, (1) the gift of stock was to someone who was active and knowledgeable in the affairs of the corporation and who intended to control its operations in the future, and (2) the intended purpose of the gift was solely for the purpose of leaving his son the business, the transaction did not have as one of its principal purposes the avoidance of Federal income tax.\textsuperscript{60}

In Revenue Ruling 77-455,\textsuperscript{61} the Internal Revenue Service held that the avoidance of Federal income tax, within the meaning of section 302(c)(2)(B) of the Code, will not be considered to be one of the principal purposes of A's sale of a portion of his corporate stock to his son.\textsuperscript{62} The Service found Revenue Ruling 77-293 as controlling in this situation since, under similar circumstances, the

\textsuperscript{54} Rev. Rul. 71-426, 1971-2 C.B. 173 (shareholder who continued to be a trustee of a voting trust was precluded from waiving the family attribution rules).

\textsuperscript{55} 61 T.C. at 560.

\textsuperscript{56} I.R.C. § 302(c)(2)(B)(ii).


\textsuperscript{58} 1977-34 I.R.B. 9.

\textsuperscript{59} \textit{Id}.

\textsuperscript{60} \textit{Id.} at 10.


\textsuperscript{62} \textit{Id.} at 7.
proposal did not have tax avoidance as one of its principal purposes.\textsuperscript{63}

In summary, shareholders of closely-held corporations must carefully consider any plan which would be considered as retaining an interest in the corporation after a section 302(b)(3) redemption. Although some connection between the distributee and the corporation is permissible,\textsuperscript{64} a finding of corporate involvement or financial dependence will render waiver of the family attribution rules impermissible.\textsuperscript{65}

\textbf{SECTION 306: THE EXCEPTIONS TO SECTION 306(a) AND REVENUE RULING 77-455}

Upon a sale or other disposition of section 306 stock, section 306(a) divides the amount realized into two categories.\textsuperscript{66} If section 306 stock is redeemed, the amount realized will be treated as a distribution to which section 301 applies.\textsuperscript{67} However, if the stock is sold or otherwise disposed of, other than by redemption, a portion of the amount realized will be treated as ordinary income. Ordinary income will be realized to the extent of that which would have been a dividend at the time of the stock distribution if money equal to the fair market value of the stock had been distributed originally.\textsuperscript{68} In other words, that portion which would have been a cash dividend, rather than a distribution of section 306 stock, will be treated as an ordinary gain from the sale of property which is not a capital asset; and "any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock disposed of, shall be treated as gain from the sale of a capital asset."\textsuperscript{69} This treatment of the amount realized as ordinary income under sections 301 and 306 can be waived in certain circumstances.\textsuperscript{70}

\textsuperscript{63} Id. The Service enumerated the same two criteria found in the previous ruling. See text at note 60 \textit{supra}.

\textsuperscript{64} See Estate of Lennard v. Commissioner, 61 T.C. 554 (1974).


\textsuperscript{66} I.R.C. § 306(a)(1), (2). See note 13 \textit{supra}.

\textsuperscript{67} I.R.C. § 306(a)(2). Section 301 provides that the amount constituting a dividend, as described in § 316, is taxable and that portion which is not a dividend reduces the basis of the section 306 stock, any excess being treated as gain from the sale or exchange of property. I.R.C. § 301(c). See also B. Brtiker & J. Eustice, supra note 6, at 10-8.

\textsuperscript{68} I.R.C. § 306(a)(1).


\textsuperscript{70} See I.R.C. § 306(b) which provides exceptions to the general rule set forth in § 306(a).
Section 306(b)(1)(A) of the Code provides an exception to the general rule of section 306(a) if the disposition (1) is not a redemption, (2) is not, directly or indirectly, to a person the ownership of whose stock would be attributable to the shareholder under section 318(a), and (3) terminates the entire, actual or constructive, stock interest of the shareholder in the corporation. Another exception is found in section 306(b)(1)(B). If the section 306 stock is redeemed and the redemption meets the criteria of section 302(b)(3), the disposition will receive capital gain treatment. The apparent justification for these exceptions to section 306(a) is that there is no bail-out if the shareholder disposes of his 'section 306 stock' either after or simultaneously with the sale of his other stock, since the same result could have been achieved by selling his original shares before the 'section 306 stock' was distributed to him.

However, in Revenue Ruling 77-455 the exception of section 306(b)(1)(A) does not apply because shareholder A proposes to sell a portion of his section 306 stock to his son, the ownership of which would be attributable to A under section 318(a). The Service also held section 306(b)(1)(B) to be inapplicable, since this exception only applies if the disposition is entirely by redemption. Hence, the net result in applying these two sections is that shareholder A would not be exempt from ordinary income treatment under section 306(a).

This situation can be provided for by the use of the exception found in section 306(b)(4)(B). If the stock with respect to which the section 306 stock was issued, is disposed of before or at the same time as the disposition of the section 306 stock, and if the taxpayer establishes that the disposition was not pursuant to a plan having Federal income tax avoidance as one of its principal purposes, then the dividend treatment of section 306 will not

72. The constructive ownership rules of § 318(a) apply in determining whether the taxpayer's entire interest has been terminated, but these attribution rules may be waived under certain circumstances as provided in § 302(c)(2).
73. B. Bittker & J. Eustice, supra note 6, at 10-11.
74. Since under I.R.C. § 318(a)(1) the father is regarded as constructively owning his son's stock, and since § 306(b)(1)(A)(ii) recognizes this and provides no waiver thereof, the father, shareholder A, is considered as constructively owning his son's stock for purposes of § 306(b)(1).
76. See note 24 supra. See (1978) 3 FED. TAX. REP. (CCH) ¶ 2340.85 for an outline of the criteria to which the Internal Revenue Service looks in determining
have any application.  

In *Fireoved v. United States*, the taxpayer combined his wholly-owned corporation with a partnership to form a new corporation. He exchanged 100 shares of common stock and 65 shares of preferred stock from the old corporation for equal amounts of the new corporation's stock. The new corporation issued an additional 535 shares of preferred stock as a dividend on the taxpayer's 100 shares of common due to his larger contribution to capital than the other members of the corporation. After a period of time the taxpayer redeemed 451 shares of his preferred stock and reported the proceeds of the redemption as a capital gain, whereupon the government assessed a deficiency on the basis of section 306. The district court held that selling twenty-four per cent of the underlying common stock allowed a proportionate amount of the preferred stock, received as a dividend, to come within an exception to the punitive rules of section 306, thereby qualifying it for capital gain treatment. The Third Circuit Court of Appeals reversed, holding that the taxpayer retained essentially the same control over the corporation that he had previously, namely, a veto power; therefore, no portion of the amount realized from subsequent redemption of section 306 stock was exempted from ordinary income treatment by reason of a partial sale of the underlying common stock. The court, relying on legislative history, reasoned that Congress recognized a lack of purposeful tax avoidance when a taxpayer sells all of his control in a corporation and subsequently redeems his section 306 stock; however, “it would be unrealistic to conclude that Congress meant to give that taxpayer the advantage of section 306(b)(4)(B)” when the taxpayer retains essentially the same control as he previously had in the corporation.

whether tax avoidance is one of the principal purposes of a section 306 stock sale or disposition.


78. 462 F.2d 1281 (3d Cir. 1972).

79. Id. at 1283.

80. Id.

81. Id.


83. 462 F.2d at 1289-90. See also Rev. Rul. 75-247, 1975-1 C.B. 104, which follows *Fireoved*. The Service held that the disposition by taxpayers of part of their section 306 stock, issued in a recapitalization, simultaneously with a pro rata portion of common stock with respect to the section 306 stock, by itself, establishes the absence of tax avoidance as one of its principal purposes.

84. 462 F.2d at 1289.
STOCK REDEMPTIONS

Some tax scholars interpreting section 306(b)(4)(B) maintain that this section should apply when a taxpayer redeems only a portion of his holdings of common stock.85 They assert that the Treasury Regulations86 have rendered section 306(b)(4)(B) “superfluous” by suggesting that this section only applies when there is a complete termination of the shareholder’s interest in the issuing corporation.87

The Internal Revenue Service held that the exception to section 306(a) provided by section 306(b)(4)(B) applies in the circumstances present in Revenue Ruling 77-455.88 The avoidance of Federal income tax within the meaning of section 306(b)(4) is not considered to be one of the principal purposes of the proposed sale by shareholder A of his section 306 stock to his son, or of the redemption by the corporation of the remaining section 306 stock, because it is inappropriate to impute to the redeeming shareholder an intention to remove corporate earnings and profits at capital gains rates.89

A taxpayer should proceed with caution if he wishes to dispose of section 306 stock without simultaneously disposing of his entire voting stock upon which the section 306 stock is based. As set forth in Fireoved, any plan which does not terminate the entire interest, as was done in Revenue Ruling 77-455, will be subjected to a strict interpretation of section 306(b)(4)(B).90

TAX PLANNING: SECTION 302, 306, 318 AND REVENUE RULING 77-455

The tax framework which a lawyer or accountant establishes for his client should be designed to avoid, or to at least minimize, potential tax consequences and liabilities before they arise. The purpose of this section is to enumerate some of the possible alternatives which the tax specialist can consider in light of the previ-

86. Treas. Reg. § 1.306-2(b)(3), T.D. 6969, 1968-2 C.B. 126. The regulation provides an example involving a shareholder who had received a dividend of 100 shares of section 306 stock on his 100 shares of common, and who sold all of the common. It is stated that “subsequent disposition of his section 306 stock would not ordinarily be considered a disposition, one of the principal purposes of which is the avoidance of Federal income tax.” Id.
87. Metzer, supra note 85, at 789. See also Trimble supra note 85, at 359-60.
89. Id.
ously discussed Code sections and Revenue Ruling 77-455. Two areas will be examined here: (1) a gift of stock and (2) a retention of some interest in the corporation after the termination of the shareholder's pecuniary interest.

First, let us consider the effect that stock gifts have on the redemption process. In Revenue Ruling 56-55691 the owner of a corporate automobile franchise and his wife held 255 shares of common stock in the corporation. The remaining 80 shares were owned by their son, having received them as a gift from his father.92 At the time of the gift the father had no intention of retiring from the business; however, within ten years from the date of the gift the father decided to retire.93 Under a proposed plan the son was to purchase 50 shares of his parents' stock and the remaining 205 shares held by the parents were to be redeemed by the corporation.94 At the same time, both husband and wife terminated their interests in the corporation as directors, officers and employees. Further, they complied with the remaining requirements of section 302(c) (2) (A) of the Code.95 The Internal Revenue Service held that under these circumstances the disposition by the father of a portion of his stock, by way of gift, to his son did not have as one of its principal purposes the avoidance of Federal income tax under section 302(c) (2) (B).96

This ruling in conjunction with Revenue Rulings 77-455 and 77-29397 offers guidance in the area of prior transfers of stock to members of the family covered under the constructive ownership doctrine of section 318 and the exceptions thereto under section 302(c) (2) (A). The business motive for the transaction appears to be controlling in all of these rulings.98 The criteria which the Serv-

91. 1956-2 C.B. 177.
92. Id. at 178. Under § 318(a) (1) the father would be considered as constructively owning the son's portion of the stock.
93. Id.
94. Id.
95. Id. The remaining requirements are: (1) not acquiring an interest in the corporation within ten years, and (2) filing an agreement with the Secretary to notify him if they should require an interest or render any services within ten years from the date of the distribution. I.R.C. § 302(c) (2) (A) (ii), (iii).
96. Rev. Rul. 56-556, 1956-2 C.B. 177 at 178-79. See also Rev. Rul. 57-387, 1957-2 C.B. 225 (previous gifts were not in contemplation of the present redemption and the only purpose of the plan was to terminate the shareholder's interest; therefore, the distributions and acquisitions by the distributees within a 10 year period did not have the avoidance of Federal income tax as one of its principal purposes); Rev. Rul. 56-584, 1956-2 C.B. 179 (the Service ruled the at the time of the gift there were no plans for a redemption, and there were bona fide business reasons for the gift, i.e., to encourage the son's interest in the corporation; therefore, the gift did not have as one of its principal purposes the avoidance of Federal income tax).
97. See notes 57-61 supra.
98. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 36 (1954) which makes refer-
ice emphasizes in its most recent rulings are: (1) a sale or transfer by gift to someone who is active and knowledgeable in the affairs of the business and who intends to control and manage the business in the future, and (2) a sale or transfer by gift for the purpose of allowing the father to retire from the business.\textsuperscript{99}

Whether the Internal Revenue Service has determined that business motive is now controlling is unclear. Despite their reliance on the business motive principal and Congress’ reference to it,\textsuperscript{100} there appears nowhere in the statute any language to that effect.\textsuperscript{101} It is abundantly clear in all of these instances that the Internal Revenue Service will carefully scrutinize any scheme which appears to have as one of its principal purposes the avoidance of Federal income tax. While the net effect of these decisions appears to be that the tax specialist can form a proposal to fit within section 302(b), it should be noted that the above-mentioned Revenue Rulings may be limited to their facts.\textsuperscript{102} Nevertheless, if the tax framework which is established does not strictly follow the fact situation in the above-mentioned holdings, they may serve as a basis by which the tax specialist can obtain an advance ruling.\textsuperscript{103}

The second area of concern is where the redeeming shareholder retains some interest after the distribution. Generally speaking, in order for there to be a waiver of the family attribution rules, there must be a complete termination of interest in the redeeming corporation.\textsuperscript{104} However, there are exceptions to this gen-

\textsuperscript{99}. Rev. Rul. 77-455, 1977-50 I.R.B. 6, at 7; Rev. Rul. 77-293, 1977-34 I.R.B. 9, at 10. \textit{But see} Rhodes Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (court upheld the taxing of the transaction as ordinary income because the substance of the transfer was an assignment of anticipated income).

\textsuperscript{100}. \textit{See} note 98 \textit{supra}.

\textsuperscript{101}. \textit{See generally} I.R.C. §§ 302, 306.


Tax avoidance within the meaning of section 302(c)(2)(B) of the Code would occur, for example, if a taxpayer transfers stock of a corporation to a spouse in contemplation of the redemption of the remaining stock . . . and terminates all direct interests . . . in compliance with section 302(c)(2)(A), but with the intention of retaining effective control . . . indirectly through the stock held by the spouse. Another example, which would generally constitute tax avoidance within the meaning of this provision, is the transfer by a taxpayer of part of the stock of a corporation to a spouse in contemplation of the subsequent redemption of the transferred stock from the spouse.\textit{Id.} at 10.


eral rule.

One such instance is where the redemption qualifies under section 301(b)(3) when the shareholder terminates his proprietary interest in the corporation but retains or acquires some other interest in the corporation. Revenue Ruling 76-524\textsuperscript{105} holds that the redemption of stock by a shareholder is a complete termination of interest for purposes of section 302(b)(3) and qualifies under section 302(a), even though the shareholder retains the positions of chairman of the board and president of the corporation.\textsuperscript{106} The Internal Revenue Service reasoned that since all the stock which would be attributable to the shareholder had been redeemed, section 302(b)(3) by itself does not place any barriers on the retention of some interest after the redemption, as long as the entire stock interest is terminated.\textsuperscript{107}

Revenue Ruling 77-467\textsuperscript{108} presented an instance where the Service was asked whether there was a “prohibited interest” fatal to the waiver of the family attribution rules.\textsuperscript{109} Here, the parent-shareholder wished to retire from the business and terminate all of his interest therein. He was concerned that the receipt of a payment representing an arm’s length charge for the corporation’s use of a building owned by the taxpayer would subject him to unfavorable tax treatment under sections 301 and 302(b)(3).\textsuperscript{110} The Service held that such an interest would not preclude the waiver of the family attribution rules since the payments were not dependent on the corporation’s future earnings or subordinate to the corporation’s general creditors.\textsuperscript{111} The landlord-tenant relationship will not provide the redeeming shareholder with a greater interest in the corporation than that of any other creditor.\textsuperscript{112}

\begin{itemize}
\item\textsuperscript{105} 1976-2 C.B. 94.
\item\textsuperscript{106} Id. at 95.
\item\textsuperscript{107} Id. at 94. Cf. Rev. Rul. 70-639, 1970-2 C.B. 74 (an interest as a landlord is not a retention of an interest in the corporation).
\item\textsuperscript{108} 1977-51 I.R.B. 11.
\item\textsuperscript{109} Id.
\item\textsuperscript{110} Id.
\item\textsuperscript{111} Id. See also Claude J. Lisle, 45 T.C.M. (P-H) 616 (1976) (held installment payments, with retention of right to vote, escrowing of stock, and right to sell on default as additional security, did not affect termination of interest under § 302(b)(3)).
\item\textsuperscript{112} See Treas. Reg. § 1.302-4(d), T.D. 6969, 1968-2 C.B. 126. See also Rev. Proc. 77-45, 1977-51 I.R.B. 20, amplifying Rev. Proc. 72-9, 1972-1 C.B. 718, where the Internal Revenue Service stated that it would not issue advance rulings or determination letters as to whether § 302(b) applies to a redemption if, the corporation continued to rent property from the shareholder whose stock was redeemed and payments were dependent upon the corporation’s future earnings and profits or subordinate to the claims of the general creditors of the corporation.
\end{itemize}
In order for the taxpayer to receive favorable tax status in this area, the Internal Revenue Service makes the distinction between a proprietary interest and some other interest retained or acquired in the corporation after the redemption. Where there is a retention of some other interest in the corporation, if that interest is that of a creditor whose payment is not dependent upon the earnings of the corporation or whose interest is not subordinated to the corporation's general creditors, then it will not be considered an interest in the corporation for purposes of section 302(b) (3).  

CONCLUSION

Congress enacted section 302 to prevent corporations from conferring a disguised dividend on shareholders by redeeming stock on a pro rata basis. The provision manifests a legislative intent to restrict the circumstances in which redemptions of stock resulting in withdrawal of earnings and profits produce capital gains rather than ordinary income. The drafters of the 1954 Code recognizing this problem enacted companion legislation in section 306.

Revenue Ruling 77-455 presents a factual setting whereby the Internal Revenue Service allows the taxpayer to remove the proceeds from the sale and redemption of section 306 stock at capital gains rates. Whether this ruling is an easing of the attribution rules of section 318, with regard to the section 306 stock, appears in doubt. The Service makes the implication that each situation will be examined on its facts and in all instances an appropriate business motive for the transaction must be found.

Paul J. Linstroth—'79